A Report
to the
Montana
Legislature

Financial-Compliance Audit

Montana State Fund

For the Calender Year Ended December 31, 2017

June 2018

Legislative Audit
Division

17-05B

Legislative Audit Committee

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§5-13-202(2), MCA

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Financial-Compliance Audits

Financial-compliance audits are conducted by the Legislative Audit Division to determine if an agency's financial operations are properly conducted, the financial reports are presented fairly, and the agency has complied with applicable laws and regulations. In performing the audit work, the audit staff uses standards set forth by the American Institute of Certified Public Accountants and the United States Government Accountability Office. Financial-compliance audit staff members hold degrees with an emphasis in accounting. Most staff members hold Certified Public Accountant (CPA) certificates.

The Single Audit Act Amendments of 1996 and the Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards require the auditor to issue certain financial, internal control, and compliance reports in addition to those reports required by Government Auditing Standards. This individual agency audit report is not intended to comply with these reporting requirements and is therefore not intended for distribution to federal grantor agencies. The Legislative Audit Division issues a statewide biennial Single Audit Report which complies with the above reporting requirements. The Single Audit Report for the two fiscal years ended June 30, 2017, was issued March 23, 2018. The Single Audit Report for the two fiscal years ended June 30, 2019, will be issued by March 31, 2020.

Audit Staff

Jessica Curtis
John Fine
Natalie H. Gibson
Shandell VanDonsel

Reports can be found in electronic format at:
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LEGISLATIVE AUDIT DIVISION

Angus Maciver, Legislative Auditor
Deborah F. Butler, Legal Counsel

Deputy Legislative Auditors
Cindy Jorgenson
Joe Murray

June 2018

The Legislative Audit Committee
of the Montana State Legislature:

This is our financial-compliance audit report of the Montana State Fund, a component unit of the state of Montana, for the calendar year ended December 31, 2017. This report does not contain any recommendations, and we issued an unmodified opinion on the financial statements, which means the reader can rely on the information presented.

Montana State Fund's response to our audit is on page C-1. We thank the Montana State Fund President/CEO and his staff for their cooperation and assistance during the audit.

Respectfully submitted,

/s/ Angus Maciver

Angus Maciver
Legislative Auditor

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Table of Contents

Appointed and Administrative Officials

Montana State Fund	Laurence Hubbard, President/CEO	
	Mark Barry, Vice President, Corporate Support	
	Richard Duane, Vice President, Human Resources	
	Julie Jenkinson, Vice President, Insurance Operations	
	Denise Heigh, Vice President, Insurance Operations Support	
	Kevin Braun, Vice President, General Counsel	
	Al Parisian, Vice President, Chief Information Officer	
		Term Expires
State Fund Board of Directors	Lance Zanto, Chair	2021
	Matthew C. Mohr	2019
	Lynda Moss	2021
	Jack Edward Owens	2019
	Jan VanRiper	2019
	Cliff Larsen	2021
	Jim Molloy	2021
	Laurence Hubbard, President/CEO - ex officio nonvoting member	

For additional information concerning the Montana State Fund, contact:

Laurence Hubbard, President/CEO
855 Front Street
Helena, MT 59604
(406) 495-5015
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Montana Legislative Audit Division

Financial-Compliance Audit

Montana State Fund

For the Calendar Year Ended December 31, 2017

June 2018 | 17-05B | Report Summary

In accordance with state law, the Montana State Fund Board of Directors has the authority to declare a dividend if there are sufficient excesses of assets over liabilities, after considering reserves for future claims as recommended by an independent actuary. In calendar year 2017 a dividend of approximately $40 million was declared, approximately $166 million in premium revenue was earned, and total ending net position was approximately $539 million. This is the largest dividend Montana State Fund has declared. Rates that policy holders pay are set to decrease by 8 percent beginning July 1, 2018.

Context

Montana State Fund (MSF) does not receive funding from the General Fund. Instead, MSF is supported by revenue from insurance premiums and investments. In calendar year 2017 insurance premium revenue and investment income totaled $166 million and $72 million, respectively. Total operating expenses were $226.8 million, which includes $123 million of benefit and claims payments to injured workers.

MSF is established by Title 39, Chapter 71 of the Montana Code Annotated. Operating as a nonprofit, independent public corporation, MSF functions like a private insurance carrier in a competitive marketplace. Coverage is guaranteed to all employers in Montana. MSF is governed by a seven-member board of directors appointed by the Governor. The board of directors appoints the President/CEO who oversees MSF's day-to-day operations.

In accordance with state law MSF is under the regulatory authority of the Insurance Commissioner at the State Auditor's Office (commissioner).

Claims occurring before July 1, 1990, referred to as the old fund claims, are an obligation of the primary government and are reflected on the state of Montana's financial statements.

Results

We performed work over MSF internal controls and business processes related to the payment of claim expenses, reserves for future claims payments, collection of insurance premium revenue, investment activity, reinsurance activity, and compliance with selected laws and regulations. We also considered the overall reasonableness of the financial statement presentation.

We issued an unmodified opinion on the financial statements, meaning the reader can rely on the information presented, and this report does not contain any recommendations. The prior report also did not contain recommendations to MSF.

For a complete copy of the report (17-05B) or for further information, contact the Legislative Audit Division at 406-444-3122; e-mail to **lad@mt.gov**; or check the web site at **http://leg.mt.gov/audit**
Report Fraud, Waste, and Abuse to the Legislative Auditor's FRAUD HOTLINE
Call toll-free 1-800-222-4446, or e-mail **lad@mt.gov.**

Chapter I – Introduction

Introduction

We performed a financial-compliance audit of the Montana State Fund (MSF) for the calendar year ended December 31, 2017. MSF is the only state agency operating on a calendar year.

The objectives of this audit were to:

1. Determine whether the MSF's financial statements present fairly the financial position, results of operations, and cash flows for the calendar year ended December 31, 2017.
2. Obtain an understanding of the MSF's control systems to the extent necessary to support our audit of MSF's financial statements, and if appropriate, make recommendations for improvement.
3. Determine whether MSF complied with selected applicable laws and regulations.

Our audit work included testing of MSF internal controls and business processes related to:

- Payment of claim expenses.
- Reserves for future claims payments.
- Assessment and collection of policy premiums.
- Investment activity.
- Reinsurance activity.
- Transactions and activities at calendar year-end.
- Compliance with selected laws and regulations.
- Overall reasonableness of the financial statement presentations.

Other operating expenses on the Statement of Revenues, Expenses, and Changes in Net Position includes an approximately $14.7 million accrual related to the legislatively-required transfer to the Department of Natural Resources and Conservation's Fire Suppression Fund. This accrual is recorded as an expense in calendar year 2017 and the expense is paid in calendar year 2018.

MSF personnel prepared the management discussion and analysis, financial statements and notes, and the required supplementary information beginning on page A-5 based on accounting information from the Statewide Accounting, Budgeting, and Human Resources System (SABHRS) with adjustments. Adjustments are made to present financial activity in accordance with Generally Accepted Accounting Principles

(GAAP). We issued an unmodified opinion on the financial statements, meaning the reader can rely on the information presented.

Background

MSF is a state agency operating as a nonprofit, independent public corporation that provides Montana employers with an option for workers' compensation and occupational disease insurance, and guarantees available coverage for all employers in Montana. MSF is governed by a seven-member board of directors appointed by the governor.

MSF's Board of Directors must set premium rates for claims incurred after July 1, 1990, at amounts sufficient, when invested, to carry the estimated cost of all claims to maturity, to meet the reasonable expenses of conducting the business of MSF, and to maintain a surplus over a calculated amount based on the National Association of Insurance Commissioners' risk-based capital requirements for a casualty insurer. The investments of the MSF, per state law, are managed by the Montana Board of Investments.

Pursuant to §39-71-2375 of the Montana Code Annotated, effective January 1, 2016, MSF is under the regulatory authority of the Insurance Commissioner at the State Auditor's Office (commissioner). The MSF reporting period changed to a calendar-year basis, and the calendar year 2017 financial statements present the second full calendar year of operations since the change in law took effect. Under the new law, by March 1 of each year, MSF is required to submit financial statements in a regulatory format to the Insurance Commissioner. Financial statements, completed in accordance with GAAP, will also continue to be prepared by Montana State Fund. This audit of GAAP financial statements remains a requirement per §39-71-2361, MCA, and continues to be necessary to support our audit of the state's basic financial statements.

Claims occurring before July 1, 1990, referred to as the old fund claims, are an obligation of the primary government and are reflected on the state of Montana's financial statements.

Independent Auditor's Report

LEGISLATIVE AUDIT DIVISION

Angus Maciver, Legislative Auditor
Deborah F. Butler, Legal Counsel

Deputy Legislative Auditors
Cindy Jorgenson
Joe Murray

Independent Auditor's Report

The Legislative Audit Committee
of the Montana State Legislature:

Introduction
We have audited the accompanying Statement of Net Position of the Montana State Fund as of December 31, 2017, the related Statement of Revenues, Expenses and Changes in Net Position, and the Statement of Cash Flows for the calendar year then ended, and the related notes to the financial statements which collectively comprise the Montana State Fund's basic financial statements.

Management's Responsibility for the Financial Statements
Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this responsibility includes designing, implementing, and maintaining internal controls relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility
Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal controls relevant to the Montana State Fund's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Montana State Fund's internal control, and accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Montana State Fund as of December 31, 2017, and the changes in net position and cash flows for the calendar year then ended in conformity with accounting principles generally accepted in the United States of America.

Other Matters

Required Supplementary Information

Accounting principles generally accepted in the United States of America require that the Managements' Discussion and Analysis and the risk management, retirement, and other post-employment benefits Required Supplementary Information be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by the Governmental Accounting Standards Board who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

Other Reporting Required by Government Auditing Standards

In accordance with *Government Auditing Standards*, we have also issued our report dated May 2, 2018, on our consideration of the Montana State Fund's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the Montana State Fund's internal control over financial reporting and compliance.

Respectfully submitted,

/s/ Cindy Jorgenson

Cindy Jorgenson, CPA
Deputy Legislative Auditor
Helena, MT

May 2, 2018

Montana State Fund Financial Statements

Montana State Fund
(A Component Unit of the State of Montana)
Management Discussion and Analysis
December 31, 2017

Montana State Fund (MSF) is a self-sufficient, not-for-profit workers' compensation insurance carrier. Our statutory purpose is to act as a competitive insurance carrier, providing an available market and thereby guaranteeing coverage to all employers in Montana. Operating on the premium dollars paid by the insured employers and the net proceeds from our investments, MSF is not funded by the State General Fund for primary business operations. We function like a private insurance carrier in a competitive marketplace and, as provided by law, perform all the functions and exercise all the powers of a private insurance carrier that are necessary, appropriate or convenient for the administration of the Montana State Fund.

MSF has undergone a number of changes since our creation in 1990. We continue to strive to improve efficiencies in all operational areas and have made a major investment in our safety management services as we work diligently with Montana employers in developing accident prevention programs. MSF is in the software development phase of a multi-year project to transition from our legacy policy management system to a more customer-interactive policy and billing system. Effective January 1, 2016, the State Auditor's Office, which regulates all insurance companies doing business in Montana, became responsible for oversight of MSF. Under regulation, MSF's financial reporting period transitioned to a calendar year and the oversight of its financial condition has expanded. External independent audits are completed annually of financial statements based on standards set by the National Association of Insurance Commissioners (NAIC). The State Auditor's Office requires specific information and filings throughout the year and they also conducted a Financial Condition Examination of the year ending December 31, 2016. No material findings or adjustments were required.

MSF also administers and manages the claims remaining in the Old Fund for the State of Montana. The assets of the Old Fund were completely liquidated in 2011 and benefit payments and administrative costs for claims occurring before July 1, 1990, are supported by General Fund resources as required under state law (Section 39-71-2352, MCA). Therefore, the Old Fund is considered to be part of the Primary Government for financial reporting purposes and is not included in the accompanying financial statements.

Overview of the Financial Statements

This overview is an introduction to Montana State Fund financial statements. The financial statements consist of two components: (1) basic financial statements, and (2) notes to the basic financial statements.

The Statement of Net Position presents information regarding all of MSF's assets, deferred outflows of resources, liabilities, deferred inflows of resources, and total net position.

The Statement of Revenues, Expenses, and Changes in Fund Net Position presents the financial results of operations for MSF for the year ending December 31, 2017. All changes in net position are reported as soon as the underlying event giving rise to the change occurs, regardless of the timing of the cash flows. Thus, revenues and expenses are reported in this statement for some items that will result in cash flows in future fiscal periods.

The Statement of Cash Flows details the cash used and provided by the various activities of MSF during the fiscal period. However, this statement does not consider unpaid responsibilities which have been established by contract or other underlying events during the period.

Financial Highlights

MSF continues to deliver high-quality services to Montana businesses while making continued rate reductions. MSF supports a competitive insurance market in Montana, offering a competitively priced product based upon actuarially sound rates while still fulfilling our role as the guaranteed market. The Board of Directors continued its trend of decreasing rates during 2017, approving a rate reduction of 5% effective July 1, 2017, and recently approved a rate reduction of 8% effective July 1, 2018.

The Board of Directors, based on analysis of policyholder surplus adequacy and financial results, approves the amount of dividends to be declared. MSF has declared and paid dividends to policyholders for 19 consecutive years. It is a way for MSF to share strong financial results by returning premium to those employers who help make it possible by lowering workplace injuries. A dividend of $40M (million) was declared in 2017 to qualifying policyholders.

Legislators passed Senate Bill 4 (SB4) during the November 2017 special session, which requires the Montana Board of Investments to transfer $14.7 million to Department of Natural Resources and Conservation's Fire Suppression Fund before April 1, 2018. This amount was accrued in 2017 and based on the law, MSF expects that another transfer of $15.1 million will be required in 2019.

Analysis of Financial Position and Results of Operations

The following analysis presents comparative condensed financial data for MSF.

Net Position (in thousands)

	12/31/2017	12/31/2016
Current and Other Assets	$ 227,746	$ 226,796
Capital Assets (Net)	28,219	27,687
Investments	1,437,222	1,423,772
Total Assets	1,693,187	1,678,255
Total Deferred Outflows of Resources	6,114	3,407
Current Liabilities	242,865	256,365
Long-term Liabilities	917,115	899,915
Total Liabilities	1,159,980	1,156,280
Total Deferred Inflows of Resources	229	78
Net Position:		
Net Investment in Capital Assets	28,219	27,687
Unrestricted	510,872	497,617
Total Net Position	$ 539,091	$ 525,304

MSF's overall net position increased during the year ended December 31, 2017, largely due to another year of strong investment performance. With around $1.7B in combined assets and deferred outflows of resources to meet $1.2B of liabilities and deferred inflows of resources, MSF is well-positioned to meet the commitments to policyholders that it has incurred, which is the hallmark of prudent insurance operations.

The largest component of MSF assets is investments, which increased slightly during the year ended December 31, 2017. The change in value is summarized in the following display (in thousands):

	Year Ended 12/31/17	Year Ended 12/31/16
Prior Year Market Value	$ 1,423,772	$ 1,405,963
Purchases at Cost	376,450	294,749
Sales	(398,194)	(286,661)
Net Realized Gains	26,064	11,280
Net Accretion of Bonds	(220)	(388)
Unrealized Gain (Loss)	9,350	(1,171)
Current Year Market Value	$ 1,437,222	$ 1,423,772

The most significant MSF liability is estimated claims payable, which increased slightly during the year ended December 31, 2017. This liability is increased as new claims for the year are added and decreased as claim payments are made. Additionally, changes to the estimates for prior years can increase or decrease the liability. The changes are summarized in the following display (in thousands):

	Year Ended 12/31/17	Year Ended 12/31/16
Estimated Claims Payable - Beginning	$ 921,531	$ 900,296
Incurred Claims Payable	123,028	131,254
Claim Payments	(124,870)	(110,019)
Estimated Claims Payable - Ending	$ 919,689	$ 921,531

Willis Towers Watson, an independent actuarial firm, prepares an annual actuarial study used to estimate claims liabilities for MSF and provides a range of potential costs associated with claims. MSF management selected and the Board of Directors approved an estimate within that range as the estimated claims payable, consisting of unpaid claims, reserve strengthening and claim adjustment expenses.

Changes in Net Position (in thousands)

	Year Ended 12/31/2017	Year Ended 12/31/2016
Operating Revenues:		
Net Premium Earned	$ 166,768	$ 169,677
Total Operating Revenue	166,768	169,677
Operating Expenses:		
Benefits and Claims	123,028	131,254
Personal Services	31,387	28,434
Dividend Expense	40,002	35,001
Other Operating Expense	32,470	15,903
Total Operating Expense	226,887	210,592
Net Operating Income (Loss)	(60,119)	(40,915)
Nonoperating Revenue (Expense):		
Investment Income	72,617	49,844
Other Nonoperating Revenue	1,299	1,461
Total Nonoperating Revenue (Expense)	73,916	51,305
Change in Net Position	13,798	10,390
Prior Period Adjustment	(11)	(47)
Beginning Net Position	525,304	514,961
Total Net Position	$ 539,091	$ 525,304

For the year ended December 31, 2017, MSF produced an increase in net position of $13.8M after returning $40.0M in dividends to eligible policyholders. Net premium income for the year was relatively consistent when compared to the prior year, despite a 5% rate reduction taking effect mid-way through the year. Premium retention, or the amount of premium that was retained from the prior year, was approximately 92% for the year ended December 31, 2017, which is consistent with MSF's recent history.

The accident year ultimate loss, which is the expected ultimate cost of all claims incurred during the year, was approximately 96.7% of the prior year ultimate loss, indicating relatively stable expected loss experience from period to period.

Personal services and other operating expense levels increased significantly in 2017 as compared to the prior year, mainly for two reasons. First, MSF recorded an accrual of $14.7M for an expense related to legislation passed during a 2017 special session of the Montana legislature. Second, as noted above, MSF in the process of replacing its policy management software and is therefore incurring costs that were not present in the prior year.

The final contributing factor in the $13.8M change in net position is MSF's investment income. While the rates of return from the portfolio remained relatively constant throughout the two years shown above, MSF had significantly more realized gains during 2017 than it did during 2016. In addition, the amount of unrealized gains on the portfolio were larger during 2017 than 2016. A combination of these factors resulted in investment income being nearly one and a half times larger in 2017 than in 2016.

An operating loss of ($60.1M) that includes a $40M dividend, offset by higher than expected investment income resulted in a change in net position of $13.8M.

Montana State Fund
Statement of Net Position
Montana State Fund is a component unit of the State of Montana

	December 31, 2017
ASSETS	
Current Assets	
Cash and Cash Equivalents	$ 50,398,290
Receivables, Net	79,323,199
Securities Lending Collateral	20,998,735
Other Assets	3,191,722
Total Current Assets	153,911,946
Noncurrent Assets	
Investments	1,437,221,591
Reinsurance Receivables	73,834,301
Capital Assets:	
Land	1,139,460
Other Capital Assets, Net of Depreciation	27,079,532
Total Capital Assets	28,218,992
Total Noncurrent Assets	1,539,274,884
Total Assets	1,693,186,830
DEFERRED OUTFLOWS OF RESOURCES	
Deferred Pension Outflows	6,114,106
LIABILITIES	
Current Liabilities	
Accounts Payable	25,790,818
Estimated Claims Payable	124,358,669
Unearned Premium	66,963,436
Securities Lending Liability	20,998,735
Compensated Absences	2,211,952
Policyholder Deposits	2,541,477
Total Current Liabilities	242,865,087
Noncurrent Liabilities	
Estimated Claims Payable	795,331,026
Reinsurance Funds Withheld	85,870,143
Net Pension Liability	28,108,597
Other Post Employment Benefits	6,905,704
Compensated Absences	899,983
Total Noncurrent Liabilities	917,115,453
Total Liabilities	1,159,980,540
DEFERRED INFLOWS OF RESOURCES	
Deferred Pension Inflows	229,464
NET POSITION	
Net Investment in Capital Assets	28,218,992
Unrestricted	510,871,940
Total Net Position	$ 539,090,932

The notes to the financial statements are an integral part of this statement.

Montana State Fund

Statement of Revenues, Expenses, and Changes in Fund Net Position

Montana State Fund is a component unit of the State of Montana

	For the Year Ended December 31, 2017
Net Premiums Earned	$ 166,767,685
Operating Expenses	
Benefits and Claims	123,027,744
Personal Services	31,386,672
Contractual Services	5,848,993
Supplies and Materials	1,268,458
Communications	1,119,354
Travel	212,726
Rent and Utilities	592,065
Repair and Maintenance	1,620,696
Depreciation and Amortization	1,252,147
Dividend Expense	40,002,289
Other Operating Expenses	20,498,296
Total Operating Expenses	226,829,440
Operating Income (Loss)	(60,061,755)
Nonoperating Revenue (Expenses)	
Investment Income	72,617,490
Securities Lending Income	455,083
Securities Lending Expenses	(248,206)
Loss on Retirement of Assets	(50,475)
Other Income	1,085,893
Total Nonoperating Revenue (Expenses)	73,859,785
Change in Net Position	13,798,030
Total Net Position - Beginning (As Previously Reported)	525,303,971
Prior Period Adjustment	(11,069)
Total Net Position - Beginning (As Restated)	525,292,902
Total Net Position - Ending	$ 539,090,932

The notes to the financial statements are an integral part of this statement.

Montana State Fund
Statement of Cash Flows
Montana State Fund is a component unit of the State of Montana

YEAR ENDED DECEMBER 31,	2017
Cash Flows from Operating Activities	
Receipts for Premiums	$ 166,565,560
Payments for Claims	(125,683,037)
Payments to Employees	(28,736,538)
Payments to Suppliers for Goods and Services	(16,591,022)
Payments for Dividends	(39,531,064)
Other Operating Receipts	1,251,982
Net Cash Provided by (Used for) Operating Activities	(42,724,119)
Cash Flows from Capital and Related Financing Activities	
Acquisition of Fixed Assets	(1,843,306)
Proceeds from Disposal of Fixed Assets	8,900
Net Cash Used for Capital and Related Financing Activities	(1,834,406)
Cash Flows from Investing Activities	
Purchase of Investments	(376,449,768)
Proceeds from Sales or Maturities of Investments	398,194,124
Interest and Dividends on Investments	38,120,718
Net Cash Provided by (Used For) Investing Activities	59,865,074
Net Increase (Decrease) in Cash and Cash Equivalents	15,306,549
Cash and Cash Equivalents - January 1	35,091,741
Cash and Cash Equivalents - December 31	$ 50,398,290

The notes to the financial statements are an integral part of this statement.

Montana State Fund
Statement of Cash Flows
Montana State Fund is a component unit of the State of Montana

YEAR ENDED DECEMBER 31,	2017
Reconciliation of Change in Net Position to Net Cash Provided by (Used for) Operating Activities	
Change in Net Position	$ 13,798,030
Adjustments to Reconcile Change in Net Position to Net Cash Provided by (Used for) Operating Activities	
Depreciation	1,141,685
Amortization	110,462
Loss on Sale of Fixed Assets	56,842
Gain on Sale of Fixed Assets	(6,367)
Income on Investments	(72,824,367)
Decrease (Increase) in	
Accounts Receivable	1,667,610
Reinsurance Receivables	(11,220,811)
Deferred Outflows of Resources	(2,706,704)
Other Assets	(943,221)
Increase (Decrease) in	
Accounts Payable	15,786,040
Unearned Premium	(1,216,477)
Property Held in Trust	(12,558)
Reinsurance Funds Withheld	10,130,815
Estimated Claims Payable	(1,841,936)
Pension Liabilities	4,615,864
OPEB Liability	580,853
Compensated Absences	160,121
Total Adjustments	(56,522,149)
Net Cash Provided by (Used for) Operating Activities	$ (42,724,119)

The notes to the financial statements are an integral part of this statement.

Montana State Fund
(A Component Unit of the State of Montana)
Notes to Financial Statements
December 31, 2017

1. Summary of Significant Accounting Policies

Description of Business

The Montana State Fund (MSF) is a nonprofit, independent public corporation established under Title 39, chapter 71 of the Montana Code Annotated (MCA). MSF provides Montana employers with an option for workers' compensation and occupational disease insurance and guarantees available coverage for all employers in Montana. MSF is a discretely presented component unit of the State of Montana and results are included in the State's Comprehensive Annual Financial Report. MSF's results are included in the State of Montana's financial reports because of the significance of MSF's financial relationship with the State. MSF is governed by a seven member Board of Directors appointed by the Governor. The Board has full power, authority, and jurisdiction in the administration of MSF. MSF's Board is allocated to the State of Montana, Department of Administration for administrative purposes only.

During the 1990 Montana Special Legislative Session, legislation passed establishing separate funding and accounts for claims of injuries resulting from accidents occurring before July 1, 1990, referred to as the Old Fund, and claims occurring on or after July 1, 1990, referred to as the New Fund. Hereafter, any reference to MSF refers to the New Fund or those claims occurring after July 1, 1990.

MSF functions as an autonomous insurance entity supported solely from its own revenues. All assets, debts, and obligations of MSF are separate and distinct from assets, debts, and obligations of the State of Montana. MSF administers and manages the claims remaining in the Old Fund for the State of Montana and is the administering entity for recording the financial activity related to receipt and disbursement of funds and assets held by the Old Fund. Other than the administrative fees paid for the management of the Old Fund claims, no State of Montana General Fund money is used for MSF operations.

The 2015 legislature passed SB 123, which significantly changed the regulatory oversight of MSF effective January 1, 2016. MSF was issued a Certificate of Authority, became an authorized insurer regulated by the Montana State Auditor's Office and became subject to the provisions of Title 33, Montana Insurance Code. As a result, MSF reports financial results on a calendar year basis instead of using the state's fiscal year ending June 30th.

Prior Period Adjustment

The State of Montana received a revised pension actuarial valuation subsequent to the issuance of MSF's December 31, 2016 financial statements that changed MSF's allocated share of the recorded pension liability. Accordingly, MSF restated its beginning net position to reflect this change. The net impact of the adjustment was $11K (thousand).

Basis of Presentation

The financial statements are presented in accordance with generally accepted accounting principles as prescribed by the GASB. MSF insurance operations are classified as an enterprise fund, in the proprietary fund category. MSF comprises only a part of the State of Montana's enterprise funds. The financial statements in this report reflect the financial position and results of operations and cash flows of MSF for the year ending December 31, 2017.

An enterprise fund is used to account for operations: (a) financed with debt that is secured solely by a pledge of the net revenues from fees and charges of the activity; (b) where laws or regulations require that the activity's costs of providing services be recovered with fees and charges, rather than with taxes or similar revenues; or (c) where the pricing policies of the activity establish fees and charges designed to recover its costs, where the primary focus of these criteria is on fees charged to external users.

Basis of Accounting

MSF uses the accrual basis of accounting, as defined by generally accepted accounting principles, for their workers' compensation insurance operations. Under the accrual basis, revenues are recorded in the accounting period earned, if measurable, and expenses are recorded in the period incurred, if measurable.

<u>Cash and Cash Equivalents</u>

Cash balances include demand deposits with the State Treasury. Cash equivalents are short-term, highly-liquid investments that are both readily-convertible to known amounts of cash and so near their maturity that they present insignificant risk of changes in value. MSF participates in the Montana Board of Investments' Short Term Investment Pool (STIP), an external investment pool. STIP is managed to preserve principal while providing 24-hour liquidity for state agency and local government participants. Funds may be invested for one or more days. The STIP investments and the income are owned by the participants of the pool and are managed on their behalf by BOI. The STIP portfolio is reported at net asset value. STIP balance as of December 31, 2017, was $42,709,627.

The STIP investments' credit risk is measured by investment grade ratings given individual securities. The Montana Board of Investment's (BOI) policy requires that STIP investments have a minimum of two credit ratings as provided by Standard and Poor's, Moody's, or Fitch that meet the minimum as stated in the STIP policy on the type of investment.

<u>Investments</u>

MSF holds investments in long-term debt securities, mutual funds, and real estate partnerships through the BOI. Under the provisions of the state constitution, MSF's invested assets are managed by the BOI. Securities are stated at fair value. Premiums and discounts are amortized using the scientific method over the life of the securities.

The investment risk disclosures are described in the following paragraphs.

<u>Credit Risk</u>

Credit risk is the risk that an issuer or another counterparty to an investment will not fulfill its obligation. Except for U.S. Government securities, MSF's fixed income instruments have credit risk as measured by major credit rating services.

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The U.S. Government guarantees the U.S. Government securities directly or indirectly. Obligations of the U.S. Government or obligations explicitly guaranteed by the U.S. Government are not considered to have credit risk.

MSF's investment policy for credit risk requires fixed income investments, at the time of purchase, to be rated investment grade as defined either by Moody's or by NRSRO.

Asset-backed securities are bonds backed by cash flows from principal and interest payments emanating from a Trust containing a pool of underlying assets. These securities, while sensitive to prepayments due to interest rate changes, generally have less credit risk than unsecured bonds. Their credit risk is based on the structure itself rather than balance sheet risk. This includes factors such as default rates, overcollateralization, and quality of collateral.

The MBOI's STIP investment policy specifies that STIP securities have a minimum of two credit ratings as provided by Standard and Poor's, Moody's, or Fitch that meet the minimum as stated in the STIP policy on the type of investment.

<u>Custodial Credit Risk</u>

Per policy, the BOI's custodial institution must hold short-term and long-term credit rating by at least one NRSRO with a minimum requirement of A1/P1 (short term) and A3/A-1 (long-term).

<u>Custodial Credit Risk for Cash</u>

The custodial risk for cash is the risk that, in the event of the failure of the custodial institution, the cash or collateral securities may not be recovered from an outside party. For any cash balances held as deposits of the Custodial bank or sub-custodial bank, they are held in the name of the BOI or Montana State Fund.

<u>Custodial Credit Risk for Investments</u>

Custodial credit risk for investments is the risk that, in the event of the failure of the counterparty to a transaction, BOI may not be able to recover the value of the investment or collateral securities that are in possession of an outside party. All the public securities as well as securities held by the separate public equity account managers were registered in the nominee name for the Montana Board of Investments and held in possession of BOI's custodial bank, State Street Bank. The Equity Index funds were purchased and recorded in BOI's name. Commingled fund investments are registered in the name of the Montana Board of Investments. Investments in external investment pools and in open-end mutual funds are not exposed to custodial credit risk because their existence is not evidenced by securities that exist in physical or book entry form.

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Concentration of Credit Risk

Concentration of credit risk is the risk of loss attributable to the magnitude of any single investment per issuer name. Investments explicitly guaranteed by the U.S. Government are excluded from the concentration of credit risk requirement. Concentration risk was within the policies as set by BOI.

MSF investment policy addresses concentration of credit risk which is monitored by investment staff. Exposure to individual issuers are limited except for debt obligations of the US Government, including its agencies and instrumentalities.

Interest Rate Risk

Interest rate risk is the risk that changes in interest rates will adversely affect the fair value of an investment. The Montana Board of Investments uses effective duration as a measure of interest rate risk for the MSF portfolio.

MSF's investment policy states the duration is to remain within 20% of the established benchmark in duration.

According to the STIP Investment Policy, "the STIP portfolio will minimize interest rate risk by:

1) Structuring the investment portfolio so securities mature to meet cash requirements for ongoing operations, thereby normally avoiding the need to sell securities on the open market prior to maturity;
2) Maintaining a dollar-weighted average portfolio maturity (WAM) for 60 days or less (for this purpose, the date to the next coupon reset date will be used for all floating or variable rate securities); and
3) STIP will maintain a reserve account."

The fixed coupon holdings pay a fixed rate of interest until maturity while floating rate securities pay a variable rate of interest until maturity. The portfolio held certain variable rate issues. Interest payments on these securities are based on an underlying reference rate, e.g., LIBOR.

The following table categorized investments to disclose credit and interest rate risk. Credit risk reflects the bond quality rating, by investment type, as of the December 31 report date. Interest rate risk is disclosed using effective duration. If a bond investment type is unrated, the quality type is indicated by NR (not rated). The credit quality ratings have been calculated excluding non-rated investment types. NA (not applicable) indicates the duration has not been calculated. The S&P rating service provides the credit ratings presented in the following tables. If an S&P rating is not available, a Nationally Recognized Statistical Rating Organization (NRSRO) rating is used.

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Security Investment Type	Fair Value	Credit Quality Rating*	Effective Duration*
Treasuries	$ 256,154,929	AAA	5.02
Agency/Government Related	210,360,644	AAA	3.81
Asset Backed Securities	40,677,195	AAA	1.89
Mortgage Back Securities	57,428,004	AAA	6.80
Financial-Corporate	255,019,073	A-	3.02
Industrial Corporate	304,503,779	A	4.40
Utility-Corporate	27,001,200	BBB+	2.73
Short Term Investment Pool (STIP)	42,709,627	NR	0.09
Total Fixed Income Investments	$ 1,193,854,451	AA-	3.97
Direct Investments			
Core Real Estate	$ 97,348,106		
Commingled Equity IndexFunds	188,728,660		
Total Direct Investments	$ 286,076,766		
Total Investments	$ 1,479,931,217		
Securities Lending Collateral Investment Pool	$ 20,998,735	NR	0.02

*Credit Quality Rating and Effective Duration are weighted.

Securities Lending

MSF participates in a securities lending program through the BOI. The BOI is authorized by law to lend its securities and has contracted with the custodial bank, State Street Bank and Trust, "the Bank," to lend securities to broker-dealers and other entities with a simultaneous agreement to return the collateral for the same securities in the future. The Bank is required to maintain collateral equal to 102 percent of the fair value of domestic securities and 105 percent of the fair value of international securities while the securities are on loan. On any day, including December 31, the markets may move in a positive or negative direction resulting in under or overcollateralization. The Bank compensates for market movement by recalculating on the following business day to meet the collateralization requirements. BOI and the Bank split the earnings, 80/20% respectively, on security lending activities. BOI retains all rights and risks of ownership during the loan period. State Street indemnifies BOI's credit risk exposure to borrowers.

During the year ended December 31, 2017, the Bank loaned MSF's public securities and received as collateral: U.S. dollar cash; U.S. Government and government-sponsored agency securities; U.S. corporate debt securities and structured securities rated AA-/Aa3 or higher; sovereign debt securities of the G10 nations; and debt securities issued by certain supranational agencies. The Bank does not have the ability to sell collateral securities unless the borrower defaults.

The BOI imposed no restrictions on the amount of securities available to lend during the year ended December 31, 2017. There were no failures by any borrowers to return loaned securities or pay distributions thereon during the period that resulted in a declaration and notice of Default of the Borrower. There were no losses during the year ended December 31, 2017, resulting from a borrower default.

The following table presents the market values of the securities on loan and the total collateral held as of December 31, 2017:

	Amount
Securities on loan - market value	$ 121,105,760
Collateral Cash	20,998,735
Collateral Securities	102,468,863
Collateral Total	$ 123,467,598
% of Fair Value	102%

During the year ended December 31, 2017, the BOI and the borrowers maintained the right to terminate all securities lending transactions on notice. The cash collateral received for each loan was invested, together with the cash collateral of other qualified plan lenders in the Navigator Securities Lending Government Money Market portfolio. Because the securities lending transactions were terminable at will, their duration did not match the duration of the investments made with the cash collateral received from the borrower. At year-end December 31, 2017, State Street Bank indemnified BOI's credit risk exposure to borrowers.

The average duration and average weighted final maturity for the investment fund is as follows as of December 31, 2017:

Navigator Securities Lending Portfolio	
Average Duration	8 days
Average Weighted Final Maturity	41 days

Income earned related to securities lending for the year ended December 31, 2017, was $455K. Expenses related to securities lending for the year ended December 31, 2017, were $248K.

<u>Receivables</u>

At December 31, 2017, MSF had a net receivable balance of $79.3M. The gross receivables for billed premium and claim benefits overpayments are $7.2M, which are then reduced by the estimated uncollectible receivables reported as an allowance for doubtful accounts of $2.1M. Other receivables include $61.9M in unbilled premium, $8.1M in investment income due, $22K in retrospective premium and $252K in notes receivable, all of which are short term. Accounts receivable also includes $3.9M at December 31, 2017, for premium that is earned but unbilled (EBUB).

<u>Reinsurance Receivables</u>

As part of the aggregate stop loss reinsurance program, MSF records a receivable for each contract year's funds withheld amount until the loss performance for that contract year is known. The receivable is increased as interest accrues and decreased with the development of recoverable or in the event of a commutation. The reinsurance receivables were $73.8M at December 31, 2017.

Equipment, Accumulated Depreciation and Intangible Assets

Equipment and intangible assets are capitalized if the actual or estimated historical unit cost exceeds $5K and $100K, respectively. Depreciation expense is computed on a straight-line basis for equipment over a period of three to ten years and amortization of intangible assets is computed on a straight-line basis over four years. Amortization of intangible assets is recorded directly to the asset balance. All fixed assets are shown net of depreciation.

Construction Work in Process

Costs for internally-generated intangible assets exceeding $500K are capitalized once activities in the preliminary project stage are completed and management authorizes and commits to funding the project. Costs incurred during the design of the chosen path, including software configuration and interfaces, coding, installation to hardware, and testing are capitalized. Amortization begins once the asset is placed in service on a straight-line basis over four years.

Other Assets

Other assets include advances and prepaid expenses.

Land and Buildings

As of December 31, 2017, MSF financial statements include $1.1M in land and $23.9M in buildings, net of depreciation. Buildings are depreciated on a straight-line basis over a period of 50 years. For additional disclosure related to capital assets, see Note 3.

Accounts Payable

Accounts payable is a short-term liability account reflecting amounts owed for goods and services received by MSF.

Estimated Claims Payable

The estimated claims payable, also called loss reserves, is established to provide for the estimated ultimate settlement cost of all claims incurred. Estimated claims payable is based on reported aggregate claim cost estimates combined with estimates for future development of such claim costs and estimates of incurred but not reported (IBNR) claims. Willis Towers Watson, an external actuarial firm, prepares an actuarial study that provides a range of potential costs associated with reported claims, the future development of those claims and IBNR. The MSF Board of Directors approved estimates within that range as the estimated claims payable for MSF. The claim costs estimated to be paid in the next year are displayed in Current Liabilities as Estimated Claims Payable and the remainder of the total is shown in Noncurrent Liabilities. For additional disclosure related to the estimated claims payable, refer to Note 5.

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Unearned Premium

Unearned premium reflects premium that has been written but not yet earned. The unearned premium was $67.0M at December 31, 2017.

Policyholder Deposits

Policyholder deposits consist of security deposits required for deposit-type policies and secure the policy with cash, letter of credit or certificate of deposit.

Reinsurance Funds Withheld

Reinsurance funds withheld represents the reinsurance funds held on behalf of the reinsurer, a requirement of MSF's aggregate stop loss reinsurance contract. Additional information regarding the funds withheld account can be found in Note 4.

Net Position

Net Position consists of the net excess or deficit of assets plus deferred outflows of resources over liabilities plus deferred inflows of resources. Net Position as of December 31, 2017, was $539.1M.

Premiums

The MSF Board of Directors approves premium rates annually. These rates are then filed with the Montana State Auditor's Office for approval in accordance with MCA, Title 33. Generally, policies are effective for the term of the policy period not to exceed 12 months. Premium revenue is recognized over the term of the policy year as it is earned or when MSF is liable for coverage.

Policyholders are contractually obligated to pay certain premiums to MSF in advance of the period the premiums are earned. Premium advances are refundable when the policyholder's coverage is canceled and all earned premiums have been credited by MSF.

2. Investments

The Company has the following recurring fair value measurements as of December 31, 2017:

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		Fair Value Measurements Using		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable (Level 3)
Investments by fair value level				
Fixed Income Investments				
Treasuries	$ 256,154,929	$ 256,154,929		
Agency/Government related	210,360,644		210,360,644	
Asset-backed securities	40,677,195		40,677,195	
Mortgage-backed securities	57,428,004		57,428,004	
Financial-corporate	255,019,073		255,019,073	
Industrial-corporate	304,503,779		304,503,779	
Utility-corporate	27,001,200		27,001,200	
Total Fixed Income Investments by fair value level	1,151,144,824	256,154,929	894,989,895	

	Fair Value	Unfunded Commitments	Redemption Frequency (If Currently Eligible)	Redemption Notice Period
Investments measured at the net asset value (NAV)				
Core Real Estate	97,348,106		Monthly, Quarterly	45-90 days
Commingled Equity Index Funds	188,728,660		Daily	1 day
Short Term Investment Pool (STIP)	42,709,627		Daily	1 day
Total Investments at NAV	328,786,393			
Total investments at fair value	$ 1,479,931,217			

MSF categorizes its fair value measurements within the fair value hierarchy established by generally accepted accounting principles as follows:

- Level 1-Quoted prices for *identical* assets or liabilities in active markets.
- Level 2-Prices determined using inputs, other than quoted prices included within Level 1, that are observable for an asset or liability, either directly or indirectly.
- Level 3-Prices determined using unobservable inputs.

Fixed income and equity index funds classified in Level 1 of the fair value hierarchy are valued using prices quoted in active markets for those securities. Fixed income investments classified in Level 2 of the fair value hierarchy are valued using a matrix pricing technique. Matrix pricing is used to value securities based on the securities' relationship to benchmark quoted prices. MSF does not classify any holdings within Level 3 of the fair value hierarchy.

MSF holds four core real estate funds which make equity investments in operating and substantially-leased

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institutional-quality real estate in the traditional property types (apartments, office, retail, industrial and hotel) via commingled funds. The primary investment objectives of these core real estate funds are to invest in real estate that will generate income from predictable sources of revenue and not realize gains on the underlying assets. This investment type receives distributions of generated income and occasionally through the liquidation of the underlying assets of the fund. The fair values of the investments in this category have been determined using the NAV per share (or its equivalent) of MSF's ownership interest in the partners' capital. Redemption of these investments is restricted based on the availability of cash flow arising from investment transactions, sales, and other fund operations occurring in the ordinary course of business. Therefore, requested redemptions from a fund will be redeemed as funds become available. As of December 31, 2017, there are no unfunded commitments.

MSF holds two commingled equity index funds which invest in domestic equities and funds that invest in international equities. The fair values of the investments of this type have been determined using the NAV per share (or its equivalent) of the investments.

The Short Term Investment Program (STIP) is managed and administered under the direction of the Board of Investments as authorized by the Unified Investment Program. It is a commingled pool for investment purposes and requested redemptions from the pool are redeemed the next business day. The fair values of the investments in this category have been determined using the NAV per share (or its equivalent) of the investment.

The amortized cost and estimated market value of MSF's fixed maturity securities as of December 31, 2017, are shown below at contractual maturity. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

	Amortized Cost	Market Value
Due one year or less	$ 61,378,571	$ 61,541,369
Due after one year through five years	692,531,597	700,775,645
Due after five years through ten years	383,322,474	383,877,784
Due after ten years	4,999,448	4,950,026
Total	$ 1,142,232,090	$ 1,151,144,824

During the year ended December 31, 2017, MSF realized gross gains from sales of securities of $26.9M and gross realized losses of ($787K). During the year ended December 31, 2017, investment income for MSF was $72.6M, which includes unrealized gains on investments in the amount of $9.3M.

3. Capital Assets

Capital assets are used for the business activities of MSF. Balances for the year ended December 31, 2017 are as follows:

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	Beginning Balances	Increases	Decreases	Ending Balances
Capital assets not being depreciated:				
Land	$ 1,139,460	$ —	$ —	$ 1,139,460
Construction Work in Process	—	1,384,541	—	1,384,541
Total capital assets not being depreciated	1,139,460	1,384,541	—	2,524,001
Capital assets being depreciated:				
Buildings/improvements	27,941,323	—	—	27,941,323
Equipment, furniture, and vehicles	7,383,772	458,764	(585,306)	7,257,230
Total capital assets being depreciated	35,325,095	458,764	(585,306)	35,198,553
Less accumulated depreciation for:				
Buildings/improvements	(3,494,994)	(530,885)	—	(4,025,879)
Equipment, furniture, and vehicles	(5,512,482)	(610,800)	525,931	(5,597,351)
Total accumulated depreciation	(9,007,476)	(1,141,685)	525,931	(9,623,230)
Total capital assets being depreciated, net	26,317,619	(682,921)	(59,375)	25,575,323
Intangible assets	230,130	—	(110,462)	119,668
Total capital assets, net	$ 27,687,209	$ 701,620	$ (169,837)	$ 28,218,992

4. Reinsurance

For the year ended December 31, 2017, MSF ceded premiums to reinsurance companies to limit the exposure arising from large losses. These arrangements consist of excess of loss contracts that protect against individual occurrences over stipulated amounts and an aggregate stop loss contract which protects MSF against the potential that aggregate losses will exceed expected levels expressed as a percentage of premiums.

The excess of loss contract provides coverage up to $100 million with an MSF retention of $5 million on the first layer of coverage. The excess of loss protection applies to an individual occurrence with a maximum of $5 million on any one life.

The term of the current aggregate stop loss contract is January 1, 2017, through January 1, 2020. The contract provides coverage based on MSF's premium levels, not to exceed 15% of the subject net earned premium. In the event reinsurers are unable to meet their obligations under either the excess of loss contracts or aggregate stop loss contract, MSF would remain liable for all losses, as the reinsurance agreements do not discharge MSF from its primary liability to the policyholders.

Premium revenue is reduced by premiums paid for reinsurance coverage of $9.8M for the year ended December 31, 2017. The aggregate stop loss contract requires that MSF maintain a funds withheld liability account which represents the basic premium portion of the total premium paid for aggregate stop loss coverage. The funds withheld liability account at December 31, 2017, is $85.9M for contracts in place from July 1, 2008, to December 31, 2017. Interest must be accrued on the funds withheld account which resulted in accrued interest of $3.9M for the year ended December 31, 2017.

Estimated claim reserves were reduced by $1.4M as of December 31, 2017, for the amount of reinsurance estimated to be ultimately recoverable on incurred losses due to the excess of loss reinsurance contracts. The estimated claim reserves were reduced by an additional $12.0M for the amount of reinsurance estimated to be ultimately recoverable on incurred losses due to the aggregate stop loss contract.

As part of the aggregate stop loss reinsurance program, MSF records a reinsurance receivable for each contract year's funds withheld amount until the loss performance for that contract year is known. The receivable is increased as interest accrues and decreased with the development of the recoverable or in the event of a commutation. The reinsurance receivables were $73.8M at December 31, 2017.

MSF also has assumed reinsurance relationships with Zurich American Insurance Company and Argonaut Insurance Company related to Other States' Coverage (OSC). MSF assumes risk related to Montana domiciled businesses with operations in other states, which are then covered under MSF's ceded reinsurance contract. For the year ended December 31, 2017, assumed premium is $3.1M and incurred losses from OSC benefits were $1.9M. The assumed liability for OSC claims is $3.5M at December 31, 2017.

5. Risk Management

MSF provides liability coverage to employers for injured employees that are insured under the Workers' Compensation and Occupational Disease Acts of Montana. Workers' compensation claims occurring on or after July 1, 1990 are reported in the MSF financials. At December 31, 2017, approximately 24,000 active policies were insured by MSF.

MSF is a self-supporting, competitive state fund and functions as the guaranteed market insurer for employers since workers' compensation insurance is mandatory in Montana. Employers may obtain coverage through private carriers, through MSF, or through self-insurance if they meet certain criteria. Public entities may self-insure or insure through MSF.

Unpaid claims and claim adjustment expenses are estimated based on the ultimate cost of settling the claims including the effects of inflation and other social and economic factors. Willis Towers Watson, an external actuarial firm, prepares an actuarial study used to estimate liabilities and the ultimate cost of settling claims reported but not settled and claims incurred but not reported (IBNR) for MSF as of December 31, 2017. Because actual claim costs depend on such complex factors such as inflation and changes in the law, claim liabilities are recomputed periodically using a variety of actuarial and statistical techniques to produce current estimates that reflect recent settlements, claim frequency, and other economic and social factors. A provision for inflation is implicit in the calculation of estimated future claim costs because reliance is placed both on actual historical data that reflects past inflation and on other factors that are considered to be appropriate modifiers of past experience.

Willis Towers Watson provides a range of potential costs associated with reported claims, the future development of those claims and IBNR. MSF management has selected a central estimate within that range as the estimated claims payable, consisting of unpaid claims and claim adjustment expenses, for December 31, 2017. The MSF estimated unpaid claims and claims adjustment expenses payable presented at face value,

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net of estimated reinsurance recoverable were $919.7M, as of December 31, 2017. The Statement of Net Position displays this total separated as current and noncurrent estimated claims payable.

State law (Section 39-71-2311, MCA) requires MSF to set premiums at least annually at a level sufficient to ensure adequate funding of the insurance program during the period the rates will be in effect. Anticipated investment income is considered when computing premium rate levels. State law also requires the MSF Board of Directors to establish surplus above risk based capital requirements to secure MSF against risks inherent in the business of insurance.

Changes in Claims Liabilities

The following table presents changes in the aggregate liabilities for MSF, net of estimated reinsurance recoverable. The information presented has not been discounted.

	2017
Unpaid claims and claim adjustment expenses at beginning of period	$ 921,531,632
Incurred claims and claim adjustment expenses:	
Provision for insured events of the current year	137,222,286
Increase(Decrease) in provision for events in prior years	(14,194,540)
Total incurred claims and claim adjustment expenses	123,027,746
Payments:	
Claims and claim adjustment expenses attributable to insured events of the current year	(24,597,387)
Claims and claim adjustment expenses attributable to insured events of prior years	(100,272,296)
Total payment	(124,869,683)
Total unpaid claims and claim adjustment expenses at the end of the period	$ 919,689,695

6. Administrative Cost Allocation

State law (Section 39-71-2352, MCA) requires MSF to separately determine and account for administrative expenses and benefit payments for claims for injuries resulting from accidents occurring before July 1, 1990 (Old Fund) from those occurring on or after July 1, 1990 (MSF). The law limits annual administrative costs of claims associated with the Old Fund to $1.25M for periods prior to July 1, 2017 and $625K for periods after that date. MSF allocated $703K in administration costs to the Old Fund for the year ended December 31, 2017. The administration costs are recorded in non-operating revenue as other income. Beginning in June 2011, the State of Montana General Fund began making transfers to cover the cost of administering and paying the Old Fund claim benefits.

7. MSF Distributions

The MSF Board of Directors declared a $40M dividend in September 2017, of which $38.6M was paid in 2017. The remaining amount was paid in 2018.

8. Compensated Absences

MSF supports two leave programs, the State of Montana Leave Program (Traditional Plan) and the MSF Personal Leave Program, implemented in January 2002. The State of Montana Leave Program covers union represented employees who have elected to remain in the plan. These employees accumulate both annual leave and sick leave and MSF pays employees 100% of unused annual leave and 25% of unused sick leave upon termination. MSF also pays 100% of unused compensatory leave credits upon termination to non-exempt employees in the Traditional Plan. The MSF Personal Leave Program covers all non-union employees, union employees hired before July 26, 2006, who have elected to adopt the plan, and all employees hired after July 25, 2007. Employees in the Personal Leave Program accumulate personal leave and extended leave. MSF pays employees for 100% of unused personal leave upon termination, but extended leave has no cash value at the time of termination.

The total MSF compensated absences liability is $3.1M as of December 31, 2017.

9. Retirement Plans

MSF and its employees contribute to the Public Employees' Retirement System (PERS), which offers two types of retirement plans administered by the Public Employees' Retirement Board (PERB), a defined benefit retirement plan (PERS-DBRP) and a defined contribution retirement plan (PERS-DCRP).

Defined Benefit Retirement Plan

Benefits provided. The PERS-DBRP is a multiple-employer, cost-sharing plan that provides retirement, disability and death benefits to plan members and their beneficiaries. Benefits are established in state law and may only be amended by the State of Montana Legislature. Members are vested after five years of membership service, which entitles the member to an accrued normal retirement benefit payable at age 60 (or age 65 if hired after June 30, 2011). A member may receive a refund of accumulated contributions in lieu of a pension, thereby forfeiting the right to a monthly benefit. A description of the benefits and eligibility rules for the plan are shown in the following table:

Eligibility for benefit	
Service retirement:	
• Hired prior to July 1, 2011:	Age 60, 5 years of membership service; Age 65, regardless of membership service; or Any age, 30 years of membership service.
• Hired on or after July 1, 2011:	Age 65, 5 years of membership service; Age 70, regardless of membership service.
Early Retirement	
Early retirement, actuarially reduced:	
• Hired prior to July 1, 2011:	Age 50, 5 years of membership service; or Any age, 25 years of membership service.

- Hired on or after July 1, 2011: Age 55, 5 years of membership service.

Second Retirement (requires returning to PERS-covered employer or PERS service):

Retire before January 1, 2016 and accumulate less than 2 years additional service credit or retire on or after January 1, 2016 and accumulate less than 5 years additional service credit:

- A refund of member's contributions plus return interest (currently .77% effective July 1, 2017).
- No service credit for second employment;
- Start the same benefit amount the month following termination; and
- Guaranteed Annual Benefit Adjustment (GABA) starts again in the January immediately following the second retirement.

Retire before January 1, 2016 and accumulate at least 2 years of additional service credit:

- A recalculated retirement benefit based on provisions in effect after the initial retirement; and
- GABA starts on the recalculated benefit in the January after receiving the new benefit for 12 months.

Retire on or after January 1, 2016 and accumulate 5 or more years of service credit:

- The same retirement as prior to the return to service;
- A second retirement benefit as prior to the second period of service based on laws in effect upon the rehire date; and
- GABA starts on both benefits in the January after receiving the original and the new benefit for 12 months.

Vesting
5 years of membership service

Member's highest average compensation (HAC)

- Hired prior to July 1, 2011 - highest average compensation during any consecutive 36 months;
- Hired on or after July 1, 2011 – highest average compensation during any consecutive 60 months;

Compensation Cap

- Hired on or after July 1, 2013 – 110% annual cap on compensation considered as a part of a member's highest average compensation.

Monthly benefit formula

- Members hired prior to July 1, 2011
  - Less than 25 years of membership service: 1.785% of HAC per year of service credit;
  - 25 years of membership service or more: 2% of HAC per year of service credit.

- Members hired on or after July 1, 2011

- Less than 10 years of membership service: 1.5% of HAC per year of service credit;
- 10 years or more, but less than 30 years of membership service: 1.785% of HAC per year of service credit;
- 30 years or more of membership service: 2% of HAC per year of service credit.

Guaranteed Annual Benefit Adjustment (GABA)
After the member has completed 12 full months of retirement, the member's benefit increases by the applicable percentage (provided below) each January, inclusive of all other adjustments to the member's benefit.

- 3.0% for members hired prior to July 1, 2007
- 1.5% for members hired between July 1, 2007 and June 30, 2013
- Members hired on or after July 1, 2013:
  a. 1.5% for each year PERS is funded at or above 90%;
  b. 1.5% reduced by 0.1% for each 2.0% PERS is funded below 90%; and
  c. 0% whenever the amortization period for PERS is 40 years or more.

Changes to benefit terms since the prior measurement date include an increase in the interest rate credited to member accounts from 0.25% to 0.77% and lump sum payments being limited to the member's accumulated contributions rather than the present value of the member's benefit.

Contributions. Contribution requirements for the plan are established in Montana Code Annotated Title 19, Chapter 3, Part 3, and can only be amended by the State of Montana Legislature. All members contribute 7.9% of their compensation. This is a temporary 1% increase for members hired prior to July 1, 2011 and remains the same for members hired on or after July 1, 2011. Interest is credited to member accounts at the rates determined by the PERB. All member contributions will be decreased to 6.9% on January 1 following the actuarial valuation results that project the amortization period to drop below 25 years and remain below following the termination of the 1% additional member contribution rate.

MSF contributes 8.47% of each member's compensation. This was increased from 6.9% to 7.035% on July 1, 2007, 7.17% on July 1, 2009, and to 8.17% on July 1, 2013. The rate will continue to increase .1% each year until 2024. These increased contributions will terminate on January 1 following the actuarial valuation results that project the amortization period to drop below 25 years and remain below following the termination of the additional employer contribution rates. Effective July 1, 2013, contributions are also made to the plan from the Coal Severance Tax Fund. The plan recognized $1,498,428 in MSF (employer) contributions during the plan year ended June 30, 2017.

Actuarial assumptions. The TPL used to calculate the NPL was determined by taking the results of the June 30, 2016, actuarial valuation and applying standard roll forward procedures to update the TPL to June 30, 2017. There were several significant assumptions and other inputs used to measure the TPL. The actuarial assumptions used in the June 30, 2017, valuation were based on the results of the last actuarial experience study, dated May 2017, for the six- year period July 1, 2010 to June 30, 2016. Among those assumptions were the following:

- Investment Return (net of admin expense) 7.65%
- Admin Expense as % of Payroll 0.26%
- General Wage Growth (includes inflation at 2.75%) 3.50%

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- Merit Increases 0% to 6.3%
- Postretirement Benefit Increases:
  Guaranteed Annual Benefit Adjustment (GABA)
  After the member has completed 12 full months of retirement, the member's benefit increases by the applicable percentage each January, inclusive of other all adjustments to the member's benefit.
  - 3.0% for members hired prior to July 1, 2007
  - 1.5% for members hired between July 1, 2007 and June 30, 2013
  - Members hired on or after July 1, 2013:
    (a) 1.5% for each year PERS is funded at or above 90%;
    (b) 1.5% reduced by 0.1% for each 2.0% PERS is funded below 90%; and
    (c) 0% whenever the amortization period for PERS is 40 years or more.
- Mortality assumptions among contributing members, terminated vested members, service retired members and beneficiaries were based on RP 2000 Combined Employee and Annuitant Mortality Tables projected to 2020 with scale BB, males set back 1 year.
- Mortality assumptions among disabled members were based on RP 2000 Combined Health Mortality Tables with no projections.

Changes in actuarial assumptions and methods since the last actuarial valuation are as follows:

Effective July 1, 2017, the following assumption changes were used:
- Lowered the interest rate from 7.75% to 7.65%.
- Lowered the inflation rate from 3.00% to 2.75%.
- Updated non-disabled mortality to the RP-2000 Combined Employee and Annuitant Mortality Table projected to 2020 using scale BB, males set back 1 year.
- Increased rates of withdrawal.
- Lowered the merit component of the total salary increase.
- Lowered the wage base component of the total salary increase from 4.00% to 3.50%.
- Decreased the administrative expense load from 0.27% to 0.26%.

Effective July 1, 2017, the following method changes were used:
- Administrative expenses are recognized by an additional amount added to the normal cost contribution rate for the System. This amount will vary from year to year based on the prior year's actual administrative expenses.
- To be consistent with the wage base growth change, the payroll growth assumption for amortization as a f pay was reduced from 4.00% to 3.50%.

Discount rate. The discount rate used to measure the TPL was 7.65%. The projection of cash flows used to determine the discount rate assumed that contributions from participating plan members, employers, and non-employer contributing entities would be made based on the Board's funding policy, which established the contractually required rates under the Montana Code Annotated. The state contributed 0.10% of the salaries paid by local governments and 0.37% paid by school districts. In addition, the state contributed coal severance tax and interest money from the general fund. The interest was contributed monthly and the severance tax was contributed quarterly. Based on those assumptions, the Plan's fiduciary net position was projected to be adequate to make all the projected future benefit payments of current plan members through the year 2121. Therefore, the long-term expected rate of return on pension plan investments was applied to all periods of projected benefit payments to determine the TPL. A municipal bond rate was not incorporated in the discount rate.

The long-term expected return on pension plan assets was reviewed as part of the regular experience study prepared for the Plan. The most recent analysis, performed for the period of July 1, 2010 to June 30, 2016, was outlined in a report dated May 2017 and can be located on the MPERA website. The long-term expected rate of return on pension plan investments was determined by considering information from various sources, including historical rates of return, rate of return assumptions adopted by similar public sector systems, and by using a building-block method in which best-estimate ranges of expected future real rates of return (expected returns, net of pension plan investment expense and inflation) are developed for each major asset class. These ranges were combined to produce the long-term expected rate of return by weighting the expected future real rates of return by the target asset allocation percentage and by adding expected inflation. Best estimates of arithmetic real rates of return for each major asset class included in the target asset allocation as of June 30, 2017, are summarized below.

Asset Class	Target Allocation	Expected Rate of Return
Cash Equivalents	2.6%	4.00%
Domestic Equity	36.0%	4.55%
Foreign Equity	18.0%	6.35%
Fixed Income	23.4%	1.00%
Private Equity	12.0%	7.75%
Real Estate	8.0%	4.00%
Total	100.0%	

The following table displays MSF's proportionate share of the net pension liability using the 7.65% discount rate as well as the proportionate share using 6.65% and 8.55%, a decrease of 1% and an increase of 1%, respectively.

	1% Decrease (6.65%)	Discount Rate (7.65%)	1% Increase (8.65%)
MSF's Proportionate Share of the Net Pension Liability	$40,937,767	$28,108,597	$17,339,477

Plan fiduciary net position. The financial statements of the Montana Public Employees Retirement Board (PERB) Comprehensive Annual Financial Report (CAFR) and the GASB 67 Report disclose the Plan's fiduciary net position. The reports are available from the PERB at PO Box 200131, Helena MT 59620-0131, (406) 444-3154 or both are available on the MPERA website at http://mpera.mt.gov

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Pension liabilities, expense, and deferred inflows and outflows of resources. At December 31, 2017, MSF reported a liability for its proportionate share of the plan's total net pension liability in the amount of $28,108,597, representing a 1.443223% share of the total based on amount of contributions by each employer. The net pension liability was measured as of June 30, 2017, and the total pension liability used to calculate the net pension liability was determined by an actuarial valuation as of June 30, 2016, with updated procedures used to roll forward the liability to June 30, 2017. There were no significant events between the measurement date and reporting date that are expected to have an impact on MSF's proportionate share of the liability.

For the year ended December 31, 2017, MSF recognized pension expense of $3,860,770 and revenue of $402,098 for support provided by the Coal Severance Tax. At December 31, 2017, MSF reported deferred outflows of resources and deferred inflows of resources related to pensions from the following sources:

	Deferred Outflows of Resources	Deferred Inflows of Resources
Actual vs. Expected Experiences	$ 692,226	$ 40,685
Changes of assumptions	3,842,151	—
Actual vs. Expected Investment Earnings	—	188,779
Changes in Proportion and Differences Between Actual Contributions and Proportionate Share Contributions	797,196	—
Contributions Subsequent to the Measurement Date	782,533	—
Total	$ 6,114,106	$ 229,464

The $782,553 reported as deferred outflows of resources related to pensions resulting from MSF contributions subsequent to the measurement date will be recognized as a reduction of the net pension liability in the year ended December 31, 2017. Other amounts reported as deferred outflows of resources and deferred inflows of resources related to pensions will be recognized in pension expense as follows:

State of Montana's year ended June 30:	
2018	$ 995,676
2019	2,197,971
2020	1,709,544
2021	(598,279)
2022	—
Thereafter	—

Defined Contribution Retirement Plan

The PERS-DCRP is a multiple-employer plan that provides retirement, disability and death benefits to plan members and their beneficiaries. Benefit terms are established in state law by the State of Montana Legislature.

Those terms are as follows:

Eligibility for benefit

Termination of service

Vesting

Immediate for participant's contributions and attributable income;

5 years of membership service for the employer's contributions to individual accounts and attributable income.

Benefit

Depends upon eligibility and individual account balance;

various payout options are available, including: taxable lump sums, periodic payments per participant direction and IRS permitted rollovers.

Member and employer contribution rates are established in state law by the State of Montana Legislature. The member contribution rate for the year ended December 31, 2017, was 7.9% of member compensation, while the MSF contribution rate was 8.47% of member compensation for the first half of the year and 8.57% for the second half. Both the member and employer rates have been temporarily increased by the Legislature and will decrease to 6.9% on January 1 following actuarial valuation results that show the amortization period of the PERS-DBRP has dropped below 25 years and will remain below 25 years following the reduction of both the additional employer and additional member contribution rates.

For the year ended December 31, 2017, MSF contributed $1.8M to the defined benefit and defined contribution plans combined. MSF cannot determine the portion of that total that relates to the defined contribution plan. Of that amount, $107K remains outstanding at December 31, 2017.

Deferred Compensation Plan

MSF and its employees are eligible to participate in the State of Montana 457(b) Deferred Compensation Plan administered by the PERB. The Deferred Compensation plan is a voluntary, tax-deferred supplemental retirement plan sponsored by the Montana Public Employee Retirement Board and held in trust for the exclusive benefit of public employees and their beneficiaries. The Plan is authorized by IRC Section 457(b) and is subject to specific Internal Revenue Service's laws and requirements. It allows employees to voluntarily contribute a portion of their compensation on a pre-tax basis. The amount invested, plus interest credited on any fixed options and any gain on the variable options, is not taxable until withdrawn at a future date. MSF incurs no costs for this plan. A summary of eligibility and benefits is shown in the following table:

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Contribution

Voluntary, pre-tax deferral or designated Roth contribution.

Eligibility for benefit

Not available to participant until separation from service, retirement, death, or upon an unforeseeable emergency, while still employed, provided IRS-specified criteria are met.

Vesting

Participants are fully vested in their accounts immediately.

Benefit

Lump sum or periodic benefit payment at the option of the participant. Based on individual account balances and plan provisions. IRS permitted rollovers are also possible.

10. Leases and Commitments

MSF leases office facilities outside of Helena under various operating leases that expire through September 2022.

MSF leases 350 parking spaces from the City of Helena in a parking garage adjacent to the MSF facility. The cost of the parking spaces is the same monthly rate as equivalent parking passes sold by the City and has the potential to change based on parking rates assigned by the Helena Parking Commission until the lease expires on June 30, 2040.

Rental expenses for the year ended December 31, 2017, were $377K, which includes $294K for the parking garage lease, $58K for office space leases, and $25K for minor office equipment.

The future minimum rental payments for office and parking space are as follows:

	Amount
2018	$ 393,643
2019	364,493
2020	332,801
2021	318,354
2022	315,150
Thereafter	5,365,500
	$ 7,089,941

During a 2017 special session of the Montana Legislature, legislators passed Senate Bill 4 (SB4) which requires the Montana Board of Investments to make a transfer of MSF assets to the Fire Suppression Fund within the Montana Department of Natural Resources and Conservation. The amount to be transferred is 3% of MSF's average invested asset balance in excess of $1 billion. The bill stipulates that one transfer be made by April 1, 2018 based on the results of 2017 and another be made by April 1, 2019 based on the results of 2018. The expense recorded in 2017 to be transferred in early 2018 is $14.7M and the expense to be recorded in 2018 and paid in early 2019 is estimated at $15.1M.

MSF is in the first phase of a multi-year project to replace its legacy policy management system. The total system replacement and change management cost is estimated to be almost $20 million. Vendor payments are based on successful completion of terms and an agreed payment schedule. Phase I payments are estimated to be about $10 million with milestones scheduled from January 2018 to September 2019. Costs during the application development phase will be capitalized and recorded as construction work in process until the system is deployed.

11. Other Post-Employment Benefits (OPEB)

Beginning with the fiscal year ending June 30, 2008, the State of Montana implemented Governmental Accounting Standards Board (GASB) Statement 45, Accounting and Financial Reporting by Employers for Post-employment Benefits Other Than Pensions. This statement requires the disclosure of employer liability for retiree medical subsidies and other post-employment benefits.

OPEB Plan Description

MSF employees and dependents are eligible to receive health care through the State Group Benefits Plan administered by the Montana Department of Administration. In accordance with section 2-18-704, MCA, the State provides optional post-employment medical, vision and dental health care benefits to the following employees and dependents who elect to continue coverage and pay administratively established premiums: (1) employees and dependents who retire under applicable retirement provisions and (2) surviving dependents of deceased employees. For GASB 45 reporting, the State Group Benefits Plan is considered an agent multiple-employer plan and MSF is considered to be a separate employer participating in the plan.

The OPEB plan allows retirees to participate, as a group, at a rate that does not cover all of the related costs. This results in the reporting of an "implicit rate subsidy" in the related financial statement and footnotes. While this liability is disclosed for financial statement purposes, it does not represent a legal liability of the State or MSF. Accordingly, reported contributions are not a result of direct funding to the plan or for associated liabilities, but are a measure of the difference in retiree payments into the plan and actual benefit costs associated with those individuals paid for by the plan.

The OPEB plan does not issue a standalone financial report.

Funding Policy

The State of Montana pays for post-employment healthcare benefits on a pay-as-you-go basis. Section 2-18-8, MCA gives authority for establishing and amending the funding policy to the Department of Administration.

For the year ended December 31, 2017, the OPEB plan's administratively-established retiree medical contributions vary between $439 and $1,633 per month depending on the medical plan selected, family coverage, and Medicare eligibility. Administratively established dental contributions vary between $41.10 and $70, and vision hardware contributions vary between $7.64 and $22.26 depending on the coverage selected.

OPEB Costs and Contributions

The annual required contribution (ARC), an amount actuarially determined in accordance with the parameters of GASB Statement 45, represents a level of funding that, if paid on an ongoing basis, is projected to cover normal cost each year of retiree health care costs and amortize any unfunded actuarial liabilities (or funding excess) over a period not to exceed thirty years.

The ARC is calculated for all the State plan's participants and then allocated to individual participants. The MSF allocated portion of the ARC for the year ended December 31, 2017, is estimated at $743K and is based on the plan's current ARC rate of 5.26% percent of participants' annual covered payroll.

The following table presents the OPEB cost, amount contributed, and changes in the OPEB liability for the year ended December 31, 2017:

Annual required contribution	$ 742,560
Interest on net OPEB obligation	277,221
Amortization factor	(217,428)
Annual OPEB cost	802,353
Contributions made	(221,500)
Increase in net OPEB obligation	580,853
Net OPEB obligation - beginning of year	6,324,851
Net OPEB obligation - end of year	$ 6,905,704

The MSF annual OPEB cost, percentage of OPEB cost contributed, and OPEB liability for the current and two prior reporting periods are as follows:

Fiscal Period Ended	Annual OPEB Cost	Percentage of Annual OPEB Cost Contributed	Net OPEB Obligation
12/31/2017	802,353	27.61%	6,905,704
12/31/2016	794,289	24.60%	6,324,851
12/31/2015	801,848	32.18%	5,679,169

The most recent actuarial valuation available as of the reporting date was as of January 1, 2015, for the year ending December 31, 2015. The valuation occurs every other year. MSF's allocation of the plan as of the most recent valuation is as follows:

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Actuarial Accrued Liability (AAL)	$8,740,886
Actuarial Value of Plan Assets	$0
Unfunded Actuarial Accrued Liability (UAAL)	$8,740,886
Funded Ratio (Actuarial Value of Plan Assets/AAL)	0%
Covered Payroll (Active Plan Members)	$21,440,983
UAAL as a Percentage of Covered Payroll	40.77%

Actuarial Methods and Assumptions

Actuarial valuations of an OPEB plan involve estimates of the value of reported amounts and assumptions about the probability of events far into the future, including future employment, mortality, and health care trends. The actuarially-determined amounts are subject to continual revision as actual results are compared to past expectations and new estimates are made about the future. Actuarial calculations reflect a long-term perspective and are based on the types of benefits provided under the terms of the substantive plan at the time of each valuation. The schedule of funding progress, presented as required supplementary information following the notes to the financial statements, provides information regarding the multi-year trend of the actuarial value of plan assets and liabilities.

The actuarial methods and assumptions used include techniques that are designed to reduce short-term volatility in actuarial accrued liabilities and the actuarial value of assets, consistent with the long-term perspective of the calculations. As of the January 1, 2015, actuarial valuation date, the projected unit cost funding method is used. The actuarial assumptions did not include an investment rate of return since no assets meet the definition of plan assets under GASB 43 or 45. Annual healthcare cost trend rates of 3.4 and 10.8 percent were used for medical and prescription claims, respectively. The unfunded actuarial accrued liability is amortized following a 30-year level percent of pay amortization on an open basis, using a 4.25 percent interest/discount rate and a 2.50 percent payroll growth rate assumption.

12. Contingencies

Susan Hensley v. Montana State Fund Montana State Fund received a Petition for Hearing that was filed before the Workers' Compensation Court in October 2013. The matter is Susan Hensley vs. Montana State Fund, WCC No. 2013-3235. The matter is fully briefed and is submitted for a decision. Under HB 334, as passed by the legislature in 2011 and codified in 39-71-703 (2), MCA, when a claimant receives a Class I impairment, it is not payable unless the claimant has an actual wage loss as a result of the compensable injury or occupational disease. The law was effective July 1, 2011 and applicable to claims that occurred on or after that date. The petitioner in this matter is challenging the constitutionality of 39-71-703 (2), MCA. State Fund anticipates the chances are remote, but as with any litigated matter there is the possibility of an adverse decision. Should the statute be held unconstitutional, determined to be applicable to other claims and also determined to be retroactively applicable, potential liability is estimated to be at least $2.2 million per year, as based on NCCI initial pricing, and current estimated business volumes. However, based on experience, costs may be substantially higher than the estimate of $2.2 million per year.

Montana State Fund received another Petition for Hearing that was filed before the Workers' Compensation Court. The matter is Steven Hanson vs. Montana State Fund, WCC No. 2014-3398. This is a companion case to Susan Hensley v. Montana State Fund and has been held in abeyance pending a decision in Hensley.

Montana State Fund also is involved in litigation in the areas of workers' compensation and disputes with policyholders. These are of a generally routine nature and there are no known matters at this time that will have a material adverse financial impact.

13. Subsequent Events

On January 22, 2018, a group of MSF policyholders filed suit against the State of Montana, MSF, and the Board of Investments, in Lake County District Court, in an effort to prevent the Board of Investments from transferring MSF's assets in accordance with SB4, as referenced in Note 10. MSF does not expect an adverse financial impact as result of this lawsuit.

REQUIRED SUPPLEMENTARY INFORMATION

Risk Management (Financial Statement Note 5)

The following table illustrates how MSF's earned revenues plus investment income compare to related costs of loss and other expenses incurred for fiscal years 2009 through 2015, the six-month period ended December 31, 2015 (shown as 2015.5), and calendar years 2016 and 2017. In addition, cumulative amounts related to estimated and actual paid claims are presented. The information allows for comparison of actual and estimated claims and is a basis for developing revenue and claims trends. As data for individual policy years mature, the correlation between original estimates and re-estimated amounts is used to evaluate the accuracy of incurred claims currently recognized for less mature policy years.

Risk Management Trend Information

(In Thousands)	2009	2010	2011	2012	2013	2014	2015	2015.5*	2016	2017
1. Premiums and Investment Revenue										
Earned	304,286	264,999	266,713	218,382	217,645	236,024	233,808	127,663	258,695	275,240
Ceded	13,702	13,224	11,286	11,501	8,459	9,460	11,310	5,545	10,447	9,841
Net Earned	290,583	251,774	255,427	206,881	209,186	226,564	222,498	122,118	248,248	265,399
2. Unallocated expenses including overhead	49,215	44,188	57,282	49,557	49,515	46,206	52,570	27,822	55,392	74,235
3. Estimated losses and expenses, end of accident year										
Incurred	159,229	137,507	142,989	118,066	128,522	139,145	124,831	66,142	128,147	126,403
Ceded	—	—	9,769	1,099	—	—	—	—	—	—
Net Incurred	159,229	137,507	133,220	116,967	128,522	139,145	124,831	66,142	128,147	126,403
4. Net paid (cumulative) as of:										
End of policy year	29,009	25,475	27,902	24,729	25,706	26,808	24,150	16,181	23,086	24,597
One year later	60,009	52,701	56,502	54,982	50,574	55,957	59,787	27,202	50,862	
Two years later	74,132	66,235	69,918	70,487	64,327	74,159	60,844	35,629		
Three years later	83,737	74,028	76,385	80,144	73,805	75,811	70,093			
Four years later	89,431	78,884	81,578	85,661	74,955	81,706				
Five years later	93,622	82,764	85,276	88,453	78,447					
Six years later	96,935	85,972	87,238	92,201						
Seven years later	100,366	87,220	89,050							
Eight years later	101,621	89,584								
Nine years later	106,896									
5. Re-estimated ceded losses and expenses	—	—	2,681	9,355	—	—	—	—	—	—
6. Re-Estimated net incurred losses and expense:										
End of policy year	159,229	137,507	133,220	116,967	128,522	139,145	124,831	74,233	128,147	126,403
One year later	152,886	139,554	134,175	130,507	123,912	134,698	140,598	69,180	124,616	
Two years later	151,738	135,833	133,652	130,281	119,972	136,257	120,835	66,085		
Three years later	151,303	135,253	133,796	119,821	120,415	126,431	118,624			
Four years later	150,212	134,681	135,734	119,313	115,453	125,011				
Five years later	149,230	133,836	134,896	115,802	113,205					
Six years later	149,291	132,963	133,600	115,694						
Seven years later	148,915	131,396	132,922							
Eight years later	146,656	129,612								
Nine years later	146,936									
7. Increase (decrease) in estimated net incurred losses and expenses from end of policy year	(12,293)	(7,895)	(298)	(1,273)	(15,317)	(14,134)	(6,207)	(57)	(3,531)	—

* Column represents the six-month period ended December 31, 2015.

Retirement Plans (Financial Statement Note 9)

Schedule of MSF's Proportionate Share of the Net Pension Liability*

June 30:	2017	2016	2015	2014
Proportion of the Net Pension Liability	1.44%	1.39%	1.39%	1.35%
Proportionate Share of the Net Pension Liability	$28,108,597	$23,678,261	$19,369,771	$16,863,200
Defined Benefit Pensionable Payroll	$17,690,906	$16,452,061	$15,976,817	$15,132,665
Proportionate Share as % of Pensionable Payroll	158.89%	143.92%	121.24%	111.44%
Plan Fiduciary Net Position as a % of Total Pension Liability	73.75%	74.71%	78.4%	79.9%

June 30:	2017	2016	2015	2014
Contractually Required Contributions	$1,498,428	$1,391,782	$1,332,551	$1,351,735
Plan Choice Rate Required Contributions	—	69,744	110,334	—
Contributions in Relation to the Contractually Req. Contributions	1,498,428	1,461,526	1,442,885	1,351,735
Contribution Deficiency (Excess)	—	(69,744)	(110,334)	—
Defined Benefit Pensionable Payroll	17,690,906	16,452,061	15,976,817	15,132,665
Proportionate Share as % of Pensionable Payroll	8.47%	8.88%	9.03%	8.93%

*This schedule is intended to show ten years of data. Additional years will be presented as they become available.

Other Post-Employment Benefits (Financial Statement Note 11)

As of December 31, 2017, the most recent actuarial valuation available that was completed by the State of Montana was as of January 1, 2015 for the year ending December 31, 2015. This actuarial evaluation is completed every two years with the next valuation to be completed as of January 1, 2017 for the year ending December 31, 2017.

The State of Montana finances claims on a pay-as-you-go basis and does not advance-fund the OPEB liability. Therefore, the funded ratio remains at 0% at December 31, 2017.

Schedule of Funding Progress

Date	Actuarial Value of Assets (A)	Actuarial Accrued Liability (AAL) (B)	Unfunded AAL (UAAL) (B-A)	Funded Ratio (A/B)	Covered Payroll (C)	UAAL as a Percentage of Covered Payroll (B-A)/C)
1/1/2015	$0	$ 8,740,886	$ 8,740,886	0.00%	$ 21,440,983	40.77%
1/1/2013	$0	$ 7,288,059	$ 7,288,059	0.00%	$ 18,899,275	38.56%
1/1/2011	$0	$ 6,355,058	$ 6,355,058	0.00%	$ 19,544,196	32.52%

Report on Internal Control and Compliance

LEGISLATIVE AUDIT DIVISION

Angus Maciver, Legislative Auditor
Deborah F. Butler, Legal Counsel

Deputy Legislative Auditors
Cindy Jorgenson
Joe Murray

Report on Internal Control Over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance with *Government Auditing Standards*

The Legislative Audit Committee
of the Montana State Legislature:

We have audited, in accordance with the auditing standards generally accepted in the United States of America and the standards applicable to the financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States, the financial statements of Montana State Fund, as of and for the calendar year ended December 31, 2017, and the related notes to the financial statements, which collectively comprise the Montana State Fund's basic financial statements, and have issued our report thereon dated May 2, 2018.

Internal Control Over Financial Reporting

In planning and performing our audit of the financial statements, we considered the Montana State Fund's internal control over financial reporting to determine the audit procedures that are appropriate in the circumstances for the purpose of expressing our opinions on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Montana State Fund's internal control. Accordingly, we do not express an opinion on the effectiveness of the Montana State Fund's internal control.

A *deficiency in internal control* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis. A *material weakness* is a deficiency, or a combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. A *significant deficiency* is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

Our consideration of internal controls was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies. Given these limitations, during our audit we did not identify

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any deficiencies in internal control that we consider to be material weaknesses. However, material weaknesses may exist that have not been identified.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Montana State Fund's financial statements are free from material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

Purpose of this Report

The purpose of this report is solely to describe the scope of our testing of internal control and compliance and the results of that testing, and not to provide an opinion on the effectiveness of the Montana State Fund's internal control or on compliance. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the Montana State Fund's internal control and compliance. Accordingly, this communication is not suitable for any other purpose.

Respectfully submitted,

/s/ Cindy Jorgenson

Cindy Jorgenson, CPA
Deputy Legislative Auditor
Helena, MT

May 2, 2018

MONTANA STATE FUND

STATE FUND RESPONSE

Montana State Fund

P.O. Box 4759, Helena, MT 59604-4759
Customer Service 800-332-6102
Fraud Hotline 888-682-7463
(888-MT-CRIME)
montanastatefund.com

June 4, 2018

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LEGISLATIVE AUDIT DIV.

Mr. Angus Maciver
Legislative Auditor
Legislative Audit Division
State Capitol Building, Room 106
Helena, MT 59620-1705

Dear Mr. Maciver:

Montana State Fund (MSF) appreciates the professionalism of the Legislative Audit Division staff in completing the financial-compliance audit of our calendar year 2017 governmental financial statements. We are pleased with your issuance of an unmodified opinion with no recommendations.

The management and staff of MSF continually strive to improve our operation and prioritize high-level service to Montana employers and employees. We thank the Legislative Audit Division for its assurance and assistance in achieving our vision as an indispensable partner in achieving a safer, healthier and more prosperous Montana.

Sincerely,

Laurence A. Hubbard
President/CEO